

BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

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Chair
Commissioner
Commissioner
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In the Matter of the Application
of Midwest Gas, a Division of
Iowa Public Service Company, for
Authority to Change Its Schedule
of Gas Rates for Retail
Customers within the State of
Minnesota

ISSUE DATE: SEPTEMBER 30, 1991

DOCKET NO. G-010/GR-90-678

ORDER DENYING PETITIONS FOR
RECONSIDERATION

PROCEDURAL HISTORY

On September 14, 1990, Midwest Gas (Midwest or the Company) filed a petition seeking a general rate increase of \$2,590,902, or 5.7%, effective November 13, 1990.

On October 16, 1990, the Commission accepted the filing, suspended the proposed rates, and ordered contested case proceedings under Minn. Stat. § 216B.16, subd. 1 (1990). The Office of Administrative Hearings assigned Administrative Law Judge Allen E. Giles to the case.

On November 9, 1990, the Commission set interim rates under Minn. Stat. § 216B.16, subd. 3 (1990). Interim rates were authorized as of November 13, 1990, and were set at a level allowing an additional \$1,210,773 in annual revenues.

On July 12, 1991, the Commission issued its FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER. In that Order the Commission found, among other things, an appropriate test year rate base of \$40,207,736, an overall rate of return of 10.144%, and a test year revenue deficiency of \$1,551,076. The Commission found that the Company had shown benefits to ratepayers of \$805,181 due to Midwest's acquisition of North Central Public Service. The Commission allowed a revenue requirement impact of \$805,181 due to the acquisition, which resulted in an acquisition adjustment to rate base of \$3,353,095.

On July 31, 1991, the Residential Utilities Division of the Office of Attorney General (RUD-OAG) filed a petition for

reconsideration. The RUD-OAG sought reconsideration solely of the Commission's standard for determining recovery of acquisition costs.

On August 2, 1991, Midwest submitted a petition for reconsideration of the Commission's July 12 Order. Midwest and the Department of Public Service (the Department) filed reply comments on August 12, 1991.

On August 16, 1991, the Company filed a petition for a variance to Minn. Rules, part 7830.4100, which requires petitions for reconsideration to be filed within 20 days of service of the Order. Midwest's petition had been filed on the 21st day.

On August 20, 1991, the Commission issued its ORDER VARYING RULES AND GRANTING PETITIONS FOR RECONSIDERATION. In that Order the Commission granted a variance of the aforementioned rule in order to allow consideration of Midwest's petition for reconsideration. The Commission granted both Midwest's and the RUD-OAG's petitions for reconsideration for the purpose of further review and final determination.

The Commission met to consider the petitions on September 13, 1991.

FINDINGS AND CONCLUSIONS

The Office of Attorney General's petition for reconsideration

THE STANDARDS

In its petition, the RUD-OAG asked the Commission to reconsider the standard it had applied to determine the level of recovery of Midwest's proposed acquisition adjustment.

When Midwest purchased Donovan Companies, Inc., the parent company of North Central Public Service (North Central) in 1986, the purchase price exceeded the book value of the assets by approximately \$12 million, of which \$7 million was allocated to the Minnesota jurisdiction. Midwest amortized the \$7 million over 30 years at an annual expense of \$233,808 and included this amount in its rate case as test year operating expenses. The Company proposed the unamortized portion of the purchase price, \$5,961,571, as an acquisition adjustment in its rate base.

In the Midwest rate case, the Commission applied what has been termed a "partial benefits" test to determine what part, if any, of the acquisition costs the Company should be allowed to recover. Under the partial benefits test, the Commission limits recovery to such acquisition costs as equal quantifiable benefits

to ratepayers directly attributable to the acquisition. When the Commission applied this test in the Midwest case, the Company was allowed recovery of \$805,181 of its acquisition costs, an amount equal to the acquisition benefits the Commission found the Company had proven. The \$805,181 recovery was allowed through the \$233,808 annual amortization of the acquisition cost in test year operating expenses and an acquisition adjustment in rate base that resulted in a test year revenue requirement impact equal to the remaining savings of \$571,373.

In its petition, the RUD-OAG argued that a "net benefits" rather than a "partial benefits" test should be applied. Under a net benefits test, as defined by the RUD-OAG, a utility must demonstrate savings from the acquisition which exceed total acquisition costs in order to recover any of those costs.

If the net benefits test were applied to the Midwest case and savings were calculated at \$805,181, the Company would not recover any acquisition costs. Savings of \$805,181 do not exceed the Company's estimated acquisition costs of \$1,249,768; according to the net benefits theory, no recovery would be allowed.

COMMISSION ANALYSIS

In determining if an acquisition adjustment may be included in rate base and operating expenses, the Commission must look to the prudence of the investment. Minn. Stat. § 216B.16, subd. 6 (1990) states that the Commission shall give due consideration to evidence of:

[t]he cost of property when first devoted to public use, to prudent acquisition cost to the public utility less accumulated depreciation on each...

As previously stated, the Commission has found that the prudence of an acquisition is best measured by quantifiable benefits to ratepayers. Utility shareholders will be allowed to recover only that amount which the Company can prove equals savings ratepayers have experienced in the rate case test year due to the acquisition. Only the cost which equals benefit will be allowed and nothing more. This concept is in consonance with the Commission's philosophy of acquisition recovery as expressed in its 1984 Inter-City Order:

...[T]here must be a showing that the cost is matched by benefits to ratepayers...

The prudent acquisition of assets is the minimum expenditure that a utility would incur, in putting the public interest

ahead of the interest of stockholders and management, for the purchase of an investment.¹

In its petition for reconsideration, the RUD-OAG argued that a net benefits test rather than a partial benefits test is the best means of ensuring that only prudent acquisition costs are recovered. The RUD-OAG cited the Inter-City Order as the basis for a net benefits test. The RUD-OAG also argued that a narrow standard is necessary for recovery of acquisition costs, because the inherently speculative nature of acquisition proposals requires heightened protection for ratepayers.

The Commission finds that Inter-City does not represent a Commission endorsement of the net benefits test. In Inter-City, the Commission disallowed a plant acquisition adjustment requested by Inter-City Gas. The Commission found that the acquired companies were in such poor financial condition that it was imprudent for Inter-City Gas to pay any amount in excess of book value. The Commission stated that "there must be a showing that the cost is matched by benefits to ratepayers, and that has not been done here where the primary benefits went to the stockholders." From this language the RUD-OAG presumably draws the conclusion that the Commission standard requires that total benefits must exceed total costs in order for any recovery to occur. The Commission finds that Inter-City did not reach the issues of partial or net benefits, since the Commission in Inter-City found **no** benefit to ratepayers and thus denied recovery. While Inter-City does stand for the fact that benefits to ratepayers attributable to the acquisition must be present before recovery will be allowed, it does not confine the Commission to a particular benefits test to determine recovery.

The Commission is also unpersuaded by the RUD-OAG's argument that the "speculative" or "soft" nature of acquisition proposals means that a net benefits test is necessary to protect ratepayers. Under this line of reasoning, anything short of an "all or nothing" net benefits test would provide an insufficient buffer for ratepayers. The Commission finds that in any rate proceeding the Commission must use its judgment and experience to form conclusions based upon the record. While an acquisition adjustment does present a scenario in which the acquired utility no longer exists, there are logical and factual means of projecting the acquired utility's financial and operational picture into the present. The Commission will always scrutinize the facts behind a proposed acquisition adjustment most carefully. Once that close scrutiny has taken place, the

¹ In the Matter of the Petition of Inter-City Gas Corporation for Authority to Change Its Schedule of Rates for Gas Service in Minnesota, Docket No. G-007/GR-83-317, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER (April 10, 1984).

Commission will determine if the acquisition is prudent. If the acquisition costs are matched or exceeded by **benefits to ratepayers** which are **quantifiable** and are **due to the acquisition**, the costs will be allowed. No recovery will be allowed if these findings are not made, and no recovery will be allowed beyond this amount. This is the standard of prudent investment which the Commission has chosen; under it, ratepayers are fully protected.

The Commission also notes the logic of two arguments raised by the Department. First, if the Commission adopted a net benefits approach, the result would be full recovery if benefits exceeded costs by one dollar and no recovery if costs exceeded benefits by one dollar. This could result in unjust treatment of very similar situations. Second, the idea of a net benefits test as a necessary protection for ratepayers would only work in cases in which costs exceed benefits. If benefits exceeded costs by one dollar, the net benefit "protection" would not exist and the utility would recover fully. These arguments simply reinforce the Commission's reliance on its standard, explained above, for determining prudent acquisition costs.

Midwest's petition for reconsideration

In its petition, Midwest asked reconsideration of three issues: the Commission's finding that ratepayer benefits must be quantifiable in order to justify a commensurate cost recovery; the Commission's decision on cost of capital savings; the Commission's denial of recovery based on gas cost savings.

QUALITATIVE BENEFITS

The Commission's finding that benefits must be quantifiable flows from the Commission's standard for determining prudent acquisition costs: the costs must equal benefits to ratepayers which would not have occurred but for the acquisition. In order for the Commission to compare costs to benefits, it is necessary that each be quantified. The Company has supplied documented evidence of its acquisition costs. The Commission has also found that the Company has supplied evidence of ratepayer benefits from the acquisition in the amount of \$805,181. The Commission has found that any proposed recovery beyond this amount is insufficiently documented or speculative, and therefore imprudent. This would include such proposed qualitative benefits as information and assistance programs and safety programs. While the Commission recognizes merit in these enterprises, it cannot fit them into its standard for determining prudent acquisitions, a standard which is absolutely essential for ratepayer protection. The Commission will not allow recovery for qualitative rather than quantitative benefits.

In Inter-City, the Commission made a reference to nonquantified, or qualitative benefits:

There may be occasions when a regulated company may pay an acquisition price in excess of book value, and show to the Commission's satisfaction that the excess price is prudent, in the public interest, and justified for ratemaking purposes without quantifying a dollar for dollar benefit comparison. However, there must be a showing that the cost is matched by benefits to ratepayers, and that has not been done here where the primary benefits went to the stockholders.

Midwest argued that Inter-City stands for a Commission endorsement of recovery for nonquantified benefits. The Commission does not agree. The Commission in Inter-City referred to nonquantified benefits in the context of its finding that benefits to ratepayers must be found before recovery will be allowed. The Commission stated that an exact cause-and-effect match of individual benefits to individual costs was not necessary to recovery. The Commission did **not** state that it would always allow recovery for nonquantified benefits. The Commission did not adopt that position in Inter-City, and will not do so now.

COST OF CAPITAL SAVINGS

In its rate case presentation, Midwest claimed the acquisition of North Central provided ratepayer savings because Midwest's current cost of capital is lower than the costs North Central would have experienced, absent the merger. The Company proposed a comparison of its test year weighted cost of debt against an estimated 1990 North Central cost of debt. The Company estimated the 1990 North Central common equity ratio at 65.8%, based on North Central's actual 1985 capital structure. The Department estimated the present North Central common equity ratio at 56.9%, the level the Commission had imputed in North Central's last rate case. The Commission found that an equity ratio of 49%, equal to the nationwide average of gas utilities, would provide the most appropriate base for the calculation of cost of capital savings.

In its petition for reconsideration, Midwest asked the Commission to apply the Department's recommended equity ratio of 56.9%. The Company asserted that North Central was a gas company with a higher than average risk factor, and the common equity ratio should therefore be higher than the industry average.

The Commission finds that the equity ratio of 49%, as set out in its July 12 Order, is the most appropriate level for the estimated North Central 1990 common equity ratio. Since North Central no longer exists, it is impossible to derive a figure which is indisputable. Basing the ratio on a published

nationwide average for gas utilities, however, is a directly fact-based method the Commission can use. It is less speculative and more closely attuned to today's industry practices than ratios drawn from either North Central's last rate case or from North Central's 1985 capital structure. The Commission finds a projected 1990 capital structure for North Central of 49% equity is appropriate.

GAS COST SAVINGS

In its petition for reconsideration, Midwest asked the Commission to reconsider its denial of recovery for gas cost savings. The Company alleged that gas cost savings arose from Midwest's ability to conduct timely zone transfers of gas and from annual benefits related to an interconnection with the Natural Gas Pipeline Company.

Zone transfers

In the rate case, Midwest claimed that its geographical diversity allowed it to respond to peak demand needs in one operating zone by transferring spot gas from other Midwest operating zones. The Company claimed that these transfer options would not have been available to North Central, requiring the use of more costly options. Therefore, according to the Company, ratepayers had realized savings of \$304,000 in 1989 and \$90,820 in 1990. Midwest argued that 1989 was a "weather normal" year while 1990 was 21% warmer than normal; therefore, costs of \$304,000 should be recovered.

The Commission disallowed recovery of costs commensurate with zone transfer "savings" because the Company did not prove that zone transfers will provide a continuing pattern of ratepayer savings or that these transactions should be isolated from other purchasing activity.

In its petition for reconsideration, the Company again asked the Commission to allow recovery of costs equal to the 1989 zone transfer "savings" of \$304,000.

The Commission finds that proposed gas cost savings due to zone transfers are highly variable and truly speculative. Thus, they do not constitute a quantifiable ratepayer benefit from the acquisition which would indicate a prudent investment. Midwest's own witnesses testified that these savings are related to spike swings in temperatures, and that savings can occur even when the weather is warmer than usual and may not occur when the weather is colder than usual. Spike weather swings may occur frequently or infrequently, or may not occur at all. Weather swings may also occur in Minnesota at the same time they occur in Iowa, eliminating the ability to make zone transfers. These facts mean that the Commission is simply unable to use the proposed figures

in its standard of prudent investment and maintain sufficient protection for ratepayers.

In addition, it may be inaccurate to view one gas cost in isolation. In the rate case, a Department witness testified that Midwest's overall cost of gas is not much better than that of much smaller companies, in spite of the suggestion that large companies have gas cost advantages. Thus, the argument that the merger of North Central into Midwest brought savings through zone transfers remains speculative.

Interconnection

In the rate case, Midwest contended that its connection of Des Moines, Iowa to a Natural Gas Pipeline Company (NGPC) line created competition between NGPC and Northern Natural Gas (NNG), a Midwest supplier. Midwest claimed that this competition and the related negotiations between Midwest and NNG resulted in direct, recurring, benefits of \$665,000 to Midwest's Minnesota customers.

The Commission disallowed the proposed savings because Midwest had not proven that the savings and concessions received from its supplier were not part of a normal business pattern unrelated to the competitive threat created by the Iowa pipeline, or that an ongoing North Central would not have obtained similar benefits in the absence of an acquisition. In its petition for reconsideration, the Company requested the Commission to reconsider its finding and allow recovery for savings due to the interconnection with NGPC.

The Commission finds that the Company's arguments regarding gas cost savings are unacceptably tenuous and speculative. It is impossible at this date to determine or to estimate with any accuracy what North Central may or may not have built in 1990 or in the years between 1986 and 1990. North Central may have built a pipeline or pipelines of its own and may have engaged in successful bargaining with suppliers based on competition. There are too many separate steps in the scenario which Midwest presented to accurately assess the gas cost savings, if any, to ratepayers. The Commission will not allow Midwest's proposed gas cost savings.

Conclusion

The Commission has carefully scrutinized the acquisition costs presented by Midwest, and has allowed **only** those costs which satisfy the Commission's conservative standard for prudent investment: acquisition costs may only be recovered up to the level of quantifiable benefits to ratepayers in the test year from the acquisition. The Commission finds that careful scrutiny and consistent application of the prudence standard are

appropriate and effective means of protecting ratepayers from any utility misuse of the acquisition process.

The RUD-OAG's petition for reconsideration seeks a prudence standard which is less logical and a less consistent means of protection for ratepayers than the Commission's. The Commission will therefore deny the RUD-OAG's petition. The Commission will also deny Midwest's petition, which seeks recovery of various savings which fail scrutiny under the Commission's standard.

ORDER

1. The petitions for reconsideration filed by Midwest Gas and the Residential Utilities Division of the Office of Attorney General are denied.
2. Within 30 days of the date of this Order, Midwest Gas shall file with the Commission for its review and approval, and serve on all other parties in this proceeding, revised schedules of rates and charges reflecting the revenue requirement and the rate design decisions contained in the Commission's July 12 Findings of Fact, Conclusions of Law and Order. The Company shall include proposed customer notices explaining the final rates. Parties shall have seven days to comment on the compliance filing.
3. Within 30 days of the date of this Order, if Midwest Gas feels it is necessary to recover the difference between interim rates and the final increase granted in the July 15, 1991 Order, in the period from that Order until implementation of final rates, it shall file a proposal for doing so with the Commission, for its review and approval.
4. Within 90 days of the date of this Order, Midwest Gas shall submit a revised goals statement for its Conservation Improvement Plan. Midwest Gas shall incorporate the concept of the conservation continuum into its goal statement and shall indicate how and when the Company's conservation programs will progress along this continuum.
5. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Richard R. Lancaster
Executive Secretary

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